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C O N F I D E N T I A L SECTION 01 OF 03 BAGHDAD 002107

SIPDIS

STATE PASS TO USAID, STATE PASS TO NEA-ROBERT SILVERMAN,  
STATE PASS TO EB-DAS LARRY GREENWOOD/TOM ENGLE, TREASURY  
PASS TO OLIN WETHINGTON

E.O. 12958: DECL: 05/19/2015

TAGS: ECON EFIN PREL IZ

SUBJECT: DEPUTY FINANCE MINISTER AZEZ'S LAST WORDS ON  
DISCUSSIONS WITH THE IMF, CBI, AND DEBT

Classified By: CLASSIFIED BY ECONOMIC MINISTER-COUNSELOR ANNE E. DERSE  
FOR REASONS 1.4 (B) AND (D)

**¶11. (SBU) SUMMARY.** Deputy Finance Minister Azez Hassan said Iraq's reporting on fiscal data to the International Monetary Fund (IMF) has improved significantly and is now strong. MOF is ready to close the books on 2004 and Azez said he expects the Budget Department to finalize by the June 6 Article IV consultations the fiscal data for at least the first two months of 2005 and "probably" through the end of March. He identified four key challenges to a successful Article IV discussion and eventual negotiation of a Stand-By Arrangement (SBA) in 2005: (1) Fuel subsidy reform; (2) Food subsidy reform; (3) Reform of state-owned enterprises; and (4) controlling inflation. Based on his knowledge of the new cabinet members of the Iraq Transitional Government (ITG), Azez is not optimistic that the first three reforms are politically feasible. Azez said inflation would actually be negatively impacted by the success of these reforms, especially with the Central Bank's lack of effective monetary policy tools. Azez's main concern, however, is that with his forced resignation (septel) there is no one who can competently manage Iraq's relationship with the IMF. Azez also said he told new ITG Finance Minister Ali Allawi that former FinMin and current Vice President Adil Mahdi needs to be included in debt negotiations with Gulf creditors because he laid down the current base. It is our impression from a recent meeting with the Charge that Mahdi agrees with Azez.  
END SUMMARY.

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REPORTING ON 2004 AND FIRST QUARTER 2005  
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**¶12. (C)** Deputy Finance Minister Azez Hassan told us on May 16 that the Ministry of Finance (MOF) Budget Department was finally prepared to close the books on 2004 fiscal data. Azez said he worked closely with the IMF last month in Washington to identify gaps in the MOF's first data submission and his staff told him earlier in the day that the data is now complete. In addition, Azez said he expects the Budget Department to finalize by the June 6 Article IV consultations in Bahrain the fiscal data for at least the first two months of 2005 and "probably" through the end of March. One significant factor missing from the 2005 data is any information from the Kurdish Region. Prior to 2005, the MOF treated the Kurdish Region as a transferred expenditure from within MOF's budget. Thus, the transfer of funds from the line item in the MOF budget to the Kurdish Region (Suleymaniyah and Irbil, which also covers Dohuk) was the only required reporting. According to Azez, the Kurdish Region insisted the 2005 budget treat the Kurdish Region as two independent spending units just like all of the line ministries. As a result, the Kurdish Region is now required to provide a detailed spending plan and report their expenditures and revenues just like every other line ministry. Azez said MOF has yet to receive any information in 2005. (Note: We later learned that officials from the Kurdish Region provided their detailed budget spending plan for 2005 to MOF on May 16, but they have yet to report any actual expenditure or revenue detail for 2004 or 2005. End Note.) Azez agreed the Minister of Finance should contact Kurdish leaders Massoud Barzani (KRG Prime Minister) and Jalal Talabani (ITG President) in writing to formally request the required expenditure information.

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SBA IS DEAD WITHOUT FUEL PRICE REFORM  
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**¶13. (SBU)** Azez reiterated what we have heard from various sources, including the IMF, in that unless the ITG acts on fuel price reform there is no chance of an SBA. Azez said the IMF expects ITG action on both the opening of the import market to the private sector and the raising of domestic, state-controlled prices for at least the two high-end petroleum products (high octane fuel and low-sulfur diesel). Azez said there are two views on how to raise prices: (1) one shot with some sort of compensation or (2) gradually without compensation. Azez favors the gradual approach without compensation, which he said is the same approach favored by

the IMF. Azez said under the gradual approach, the goal would be to eliminate the subsidy within two to three years. (Note: Iraq's commitment to the IMF is to phase out the fuel price subsidy by 2009. End Note.)

¶ 14. (C) Azez confirmed the Cabinet and National Assembly would both have to approve any significant fuel price reform. He is not optimistic about passing this reform in 2005 given the current make-up of the ITG Cabinet. In particular, Azez is concerned about the new ITG Minister of Oil, Ibrahim Bahr Al-Uloum, who, according to Azez, was the main obstacle in the Iraq Governing Council that prevented the Coalition Provisional Authority from taking action on fuel price reform back in February 2004. (Comment: In our initial discussion with Bahr Al-Uloum (septel), he recognized that the ITG will need to reform Iraq's fuel price subsidy system both for the benefit of the Iraqi budget and the negotiation of an SBA with the IMF, and the new Electricity Minister told us May 18 that Bahr Al-Uloum supported the reform, as he does. Finance Minister Allawi and Planning Minister Barham Saleh are strongly in favor of significant reform. Prime Minister al-Jafari's position remains tenuous. End Comment.)

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NEED AT LEAST A PLAN FOR FOOD AND SOE REFORM

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¶ 15. (C) Azez said he told Minister Allawi in a recent briefing on commitments to the IMF that the ITG must at least approve plans to address Iraq's food distribution system and state-owned enterprises (SOEs). Azez did not know whether the Privatization Commission established by former Prime Minister Iyad Allawi still exists under the new government. He was once again not optimistic about approval of either of these reforms since he does not think the new Cabinet will take the political risk.

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INFLATION AND THE CENTRAL BANK

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¶ 16. (SBU) Azez explained that the proposed fuel, food, and SOE reforms would all have an inflationary effect on prices (liberalization of fuel prices, monetization of food basket, and privatization of SOEs). The Central Bank of Iraq (CBI) does not have any working tools to manage inflationary pressures, according to Azez. Azez said the IMF will continue to look hard at inflation during the SBA negotiations.

¶ 17. (C) KPMG is currently in Iraq attempting to finalize the International Advisory and Monitoring Board (IAMB) audit on the Development Fund for Iraq (DFI). The Ministry of Finance has been working to identify discrepancies between the draft IAMB audit and the Ministry's figures. Several of the figures used by KPMG in the audit are the same figures available to CBI from the Federal Reserve Bank in New York (FRBNY). However, no one in the Central Bank, according to Azez, would certify the DFI balances presented by KPMG. Azez said the "records of the Central Bank are a shame -- what is happening at the Central Bank is shameful". He wasn't sure if the cause was incompetence or corruption. In reference to the possibility of continuing to work on Iraq's debt negotiations as an advisor to CBI, Azez responded that that would be impossible; he "knows the inside((and) cannot stand the CBI."

¶ 18. (C) In the context of discussing the extent of his (former) responsibilities at MOF, Azez said the CBI recently tried "in a devious way" to bring US dollars (USD) to Iraq for the daily currency auction. The Minister learned of a request for a USD 3 billion cash transfer from the FRBNY to the CBI vault in Baghdad and called Azez for an explanation. Azez said he was unaware of the transaction. He said he immediately called Governor Shabibi to stop the transfer. Azez found out the following day, May 15, that the Ministry had requested a USD 2.3 billion cash transfer to the CBI vault and the CBI requested an additional USD 700 million cash transfer from the CBI's independent account in the FRBNY. MOF officials explained to Azez that the transfer was necessary to fund letters of credit (LCs) and to buy Iraqi Dinar (ID) from the CBI for normal government operations. Azez explained that he previously set up a system with the CBI by which MOF would order the CBI to pay LCs directly out of the DFI account in the FRBNY, rather than shipping cash to Iraq then back out again to fund the LC. To fund normal government operations, MOF should tell the CBI how many ID are required and the CBI should provide them. CBI would then simply transfer USD from the DFI account in the FRBNY to the CBI account in the FRBNY to pay for the ID. MOF does not need to transfer USD into Iraq. Rather, only CBI requires USD for the daily currency auction. Azez said CBI "probably wanted to make MOF pay for the cost" of transporting the USD to Iraq.

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¶9. (C) Azez told us that he told Allawi he "needs to include" former FinMin and current Vice President Adil Mahdi in negotiations with Gulf creditors. Azez said when Allawi questions why, Azez said Mahdi "laid down the base." Everyone in the Cabinet needs to be included in these negotiations, according to Azez.

¶10. (C) VP Mahdi told the Charge in a May 12 meeting that negotiations with the Gulf creditors is a "political issue". He continued, "I don't think the Saudis want USD 800 million from us(they want contracts, assistance, etc." Mahdi said the ITG still needed to "start" negotiations with the Gulf States. (Allawi also told us this week that the ITG has yet to begin to discuss a strategy on approaching Gulf creditors). Mahdi was planning to meet with Allawi after Allawi returned from Brazil to "draw up a strategy." Mahdi hoped the ITG would have a strategy by the end of the month (May). Mahdi suggested the ITG might use the Brussels Conference on June 22 as leverage to at least push for responses from Paris Club members to previous MOF letters requesting bilateral deals better than Paris Club terms. "So far no positive responses((they are) all sticking with 80 percent." Mahdi said the ITG would send a "good team" to Brussels, led by Foreign Minister Zebari and including FinMin Allawi and Deputy Prime Minister Rowsch Shaways. They plan to have "something to say on commercial and Gulf creditors," according to Mahdi. He expects the ITG to have a "vision of all the claims" by the end of this year.

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COMMENT  
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¶11. (C) One day after submitting his resignation, Azez was noticeably more pessimistic about Iraq's progress on key reforms necessary for the negotiation of a SBA with the IMF, especially if he was not going to be involved in the process. Azez said the IMF's invitation to Allawi to participate in the Article IV consultations June 6-12 in Bahrain stated, "Azez must come," according to Azez. IMF (non)- resident representative Ibrahim Tigani called us after hearing of Azez's resignation to say the IMF is now considering what to do about the June 6 Article IV consultations. He said the IMF will probably write to Allawi re-transmitting the questionnaire that must be completed for the meeting to go forward. Without Azez in attendance, the ITG will need to impress upon the IMF during Article IV consultations that they are capable of providing the data and making the political decisions necessary to negotiate and fulfill the commitments associated with a SBA.

Jeffrey